	$'million
Assets (190 + 370)	560
Goodwill	80
	640
Share capital	250
Capital reserve (60 + 200 − 250)	10
Retained profit	140
Liabilities (70 + 170)	240
	640

¶11-800 Disclosures

HKFRS 3 requires an acquirer to disclose information that enables users of its financial statements to evaluate the nature and financial effect of business combinations that occurs during the period and after the end of the reporting period but before the financial statements are authorised for issue. To meet the objective in para 59, the acquirer should disclose the information specified in para B64 and B66.

For each business combination that occurs during the period, the acquirer should disclose the following information (para B64):

(a) the names and a description of the acquiree;

(b) the acquisition date;

(c) the percentage of voting equity equity interest acquired;

(d) the primary reasons for the business combination and a description of how the acquirer obtained control of the acquirer;

(e) a qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition or other factors;

(f) the acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as:

(i) cash;

(ii) other tangible or intangible assets, including a business or subsidiary of the acquirer;

(iii) liabilities incurred, e.g. a liability for contingent consideration; and

(iv) equity interests of the acquirer, including the number of instruments or interests issued or issuable and the method of determining the fair value of those instruments or interests;

(g) for contingent consideration arrangements and indemnification assets:

(i) the amount recognised as of the acquisition date;

(ii) a description of the arrangement and the basis for determining the amount of the payment; and

(iii) an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer should disclose that fact;

(h) for acquired receivables:

(i) the fair value of the receivables;

(ii) the gross contractual amounts receivable;

(iii) the best estimate at the acquisition date of the contractual cash flows not expected to be collected;

The disclosures should be provided by major classes of receivables, such as loans, direct finance leases and any other class of receivables;

(i) the amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed;

(j) for each contingent liability recognised in accordance with para 23, the information required in para 85 of HKAS 37 "Provisions, Contingent Liabilities and Contingent Assets". If a contingent liability is not recognised because its fair value cannot be measured reliably, the acquirer should disclose:

(i) the information required by para 86 of HKAS 37; and

(ii) the reasons why the liability cannot be measured reliably;

(k) the total amount of goodwill that is expected to be deductible for tax purposes;

(l) for transactions that are recognised separately from the acquisition of assets and assumption of liabilities in the business combination in accordance with para 51:

(i) a description of each transaction;

(ii) how the acquirer accounted for each transaction;

(iii) the amount recognised for each transaction and the line item in the financial statements in which each amount is recognised; and

(iv) if the transaction is the effective settlement of a pre-existing relationship, the method used to determine the settlement amount;

(m) the disclosure of separately recognised transactions required by (l) should include the amount of acquisition-related costs and, separately, the amount of those costs recognised as an expense and the line item or items in the statement of comprehensive income in which those expenses are recognised. The amount of any issue costs not recognised as an expense and how they were recognised should be disclosed;

(n) in a bargain purchase (see para 34 to 36):

(i) the amount of any gain recognised in accordance with para 34 and the line item in the statement of comprehensive income in which the gain is recognised;

(ii) a description of the reasons why the transaction resulted in a gain;

(o) for each business combination in which the acquirer holds less than 100% of the equity interests in the acquiree at the acquisition date:

(i) the amount of the non-controlling interest in the acquire recognised at the acquisition date and the measurement basis for that amount; and

(ii) for each non-controlling interest in an acquiree measured at its fair value, the valuation techniques and key model inputs used for determining that value;

(p) in a business combination achieved in stages:

(i) the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date; and

(ii) the amount of any gain or loss recognised as a result of remeasuring to its fair value the equity interest in the acquiree held by the acquirer before the business combination (see para 42) and the line item in the statement of comprehensive income in which that gain or loss is recognised;

(q) the following information:

(i) the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period; and

(ii) the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

If disclosure of any of the information required by this subparagraph is impracticable, the acquirer should disclose that fact and explain why the disclosure is impracticable. This HKFRS uses the term "impracticable" with the same meaning as in HKAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors".

For business combinations effected after the end of the reporting period but before the financial statements are authorised for issue, the same disclosures mentioned above should be made unless the initial accounting for the business combination is incomplete at the time the financial statements are authorised for issue. In this case, the acquirer should describe which disclosure could not be made and the reason why they cannot be made (para B66).

HKFRS 3 also requires an acquirer to disclose information that enables user of its financial statements to evaluate the financial effects of adjustments recognised in the current period that relate to business combinations that occurred in the current or in previous periods (para 61). To meet the objective of para 61, HKFRS 3 requires an acquirer to disclose the information specified in para 67.

Paragraph 67 requires disclosure of the following information:

(a) if the initial accounting for a business combination is incomplete (see para 45) for particular assets, liabilities, non-controlling interests or items of consideration and the amounts recognised in the financial statements for the business combination have been determined only provisionally:

(i) the reasons why the initial accounting for the business combination is incomplete;

(ii) the assets, liabilities, equity interests or items of consideration for which the initial accounting is incomplete; and

(iii) the nature and amount of any measurement period adjustments recognised during the reporting period in accordance with para 49;

(b) for each reporting period after the acquisition date until the entity collects, sells or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability or the liability is cancelled or expires:

(i) any changes in the recognised amounts, including any differences arising upon settlement;

(ii) any changes in the range of outcomes (undiscounted) and the reasons for those changes; and

(iii) the valuation techniques and key model inputs used to measure contingent consideration;

(c) for contingent liabilities recognised in a business combination, the acquirer should disclose information required by para 84 and 85 of HKAS 37 for each class of provision;

(d) a reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period showing separately:

(i) the gross amount and accumulated impairment losses at the beginning of the reporting period;

(ii) additional goodwill recognised during the reporting period, except goodwill included in a disposal group that, on acquisition, meets the criteria to be classified as held for sale in accordance with HKFRS 5 "Non-current Assets Held for Sale and Discontinued Operations";

(iii) adjustments resulting from the subsequent recognition of deferred tax assets during the reporting period in accordance with para 67;

(iv) goodwill included in a disposal group classified as held for sale in accordance with HKFRS 5 and goodwill derecognised during the reporting period without having previously been included in a disposal group classified as held for sale;

(v) impairment losses recognised during the reporting period in accordance with HKAS 36 (HKAS 36 requires disclosure of information about the recoverable amount and impairment of goodwill in addition to this requirement);

(vi) net exchange rate differences arising during the reporting period in accordance with HKAS 21 "The Effects of Changes in Foreign Exchange Rates";

(vii) any other changes in the carrying amount during the reporting period;

(viii) the gross amount and accumulated impairment losses at the end of the reporting period;

(e) the amounts and an explanation of any gains or losses recognised in the current reporting period that both:

(i) relate to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period; and

(ii) are of such a size, nature or incidence that disclosure is relevant to understanding the combined entity's financial statements.

¶11-850 Sample disclosures

An example of an accounting policy for the acquisition method and goodwill acquired in a business combination is shown below:

> "The acquisition method is used to account for the acquisition of subsidiaries. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange. Acquisition-related costs are expensed when incurred. Identifiable

> assets and liabilities assumed in an acquisition are measured initially at their fair values at the acquisition date. The excess of the cost of acquisition over the Group's interest in the net fair value of the subsidiary's identifiable assets and liabilities acquired is recognised as goodwill. If the cost of acquisition is less than the Group's interest in the net fair value of the subsidiary's identifiable assets and liabilities acquired, the resulting gain is recognised immediately in profit or loss on the acquisition date.
>
> Goodwill on acquisitions of subsidiaries is allocated to cash-generating units and is tested annually for impairment and carried at cost less accumulated impairment losses.
>
> On disposal of a cash-generating unit during the year, any attributable amount of acquired goodwill is included in the calculation of profit or loss on disposal."

¶11-900 Comparison with International Financial Reporting Standards

HKFRS 3 is based on IFRS 3 "Business Combinations". There are no major textual differences between HKFRS 3 and IFRS 3. Compliance with HKFRS 3 will ensure compliance with IFRS 3.

12 HKFRS 4

"Insurance Contracts"

¶12-100 Introduction

An insurance contract is defined in Appendix A of HKFRS 4 as a "contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder". This definition covers most annuity, medical, life, motor, travel, property, reinsurance and professional indemnity contracts.

Accounting practices for insurance contracts have been diverse, and often differ from practices in other sectors. The objective of HKFRS 4 is to specify the financial reporting for insurance contracts by any entity that issues such contracts (an insurer) until the second phase of the project on insurance contracts is completed. In particular, HKFRS 4 requires:

(a) limited improvements to accounting by insurers for insurance contracts; and

(b) the insurer to disclose information about those contracts.

It may be noted that HKFRS 4 is not very substantive in content (since it is just Phase I of the IASB project on insurance), and is only applicable to the insurer (and not the insured). Thus, this chapter will just briefly discuss the major provisions of HKFRS 4.

¶12-200 Scope

HKFRS 4 applies to virtually all insurance contracts (including reinsurance contracts) that an entity issues and reinsurance contracts that it holds, and financial instruments that it issues with a discretionary participation feature (para 2).

HKFRS 4 does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of HKAS 39 "Financial Instruments: Recognition and Measurement" and HKFRS 9 "Financial Instruments" (para 3).

An entity shall also not apply HKFRS 4 to (para 4):

(a) product warranties issued directly by a manufacturer, dealer or retailer (see HKAS 18 "Revenue" and HKAS 37 "Provisions, Contingent Liabilities and Contingent Assets");

(b) employers' assets and liabilities under employee benefit plans (see HKAS 19 (2011) "Employee Benefits" and HKFRS 2 "Share-based Payment") and retirement benefit obligations reported by defined benefit retirement plans (HKAS 26 "Accounting and Reporting by Retirement Benefit Plans");

(c) contractual rights or obligations that are contingent on the future use of, or right to use, a non-financial item, as well as a lessee's residual value guarantees embedded in finance leases (see HKAS 17 "Leases", HKAS 18 "Revenue" and HKAS 38 "Intangible Assets");

(d) financial guarantee contracts unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case the issuers may elect to apply either HKAS 32 "Financial Instruments: Presentation", HKFRS 7 "Financial Instruments: Disclosures", HKAS 39 "Financial Instruments: Recognition and Measurement", HKFRS 9 "Financial Instruments" or HKFRS 4 to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable;

(e) contingent consideration payable or receivable in a business combination (HKFRS 3 "Business Combinations");

(f) direct insurance contracts that an entity holds as a policyholder.

¶12-300 Recognition and measurement

The equivalent of HKFRS 4, IFRS 4 "Insurance Contracts" is Phase I of IASB's project on insurance contracts. IFRS 4 (hence HKFRS 4) exempts an insurer temporarily (until the completion of Phase II of the Insurance Project) from some requirements of other IFRS (hence HKFRS).

Specifically, HKFRS 4 exempts an insurer from applying the requirement in HKAS 8 "Accounting Policies, Changes in Accounting Estimate and Errors" to consider the *Conceptual Framework* in selecting accounting policies for insurance contracts (para 13). To bring accounting practice for insurance contracts more in line with the *Conceptual Framework*, HKFRS 4 therefore:

(a) prohibits recognition as a liability of provisions for possible future claims, if those claims arise under contracts that are not in existence at the end of the reporting period, such as catastrophe and equalisation provisions (para 14(a));

(b) requires an insurer to remove insurance liabilities from its statement of financial position when, and only when, they are extinguished, i.e. when the obligation specified in the contract is discharged or cancelled, or expired (para 14(c)).

HKFRS 4 further requires an insurer to carry out the liability adequacy test (para 14(b)). Specifically, HKFRS 4 requires an insurer to assess at the end of each reporting period whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities are inadequate, HKFRS 4 requires the entire deficiency be recognised in profit or loss (para 15).

HKFRS 4 disallows offsetting reinsurance assets against related insurance liabilities (para 14(d)). HKFRS 4 also disallows offsetting of income or expense from reinsurance contracts against the expense or income from the related insurance contracts (para 14(d)).

HKFRS 4 requires an insurer to consider whether its reinsurance assets are impaired (para 14(e)). Further, HKFRS 4 provides that a reinsurance asset is impaired if and only if:

(a) there is objective evidence, based on an event that occurred after initial recognition of the reinsurance asset, that the cedant may not receive all amounts due to it under the terms of the contract; and

(b) that event has a reliably measurable impact on the amount that the cedant will receive from the reinsurer (para 20).

HKFRS 4 permits an insurer to change its accounting policies for insurance contracts if, and only if, as a result, its financial statements are more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs (para 22). In particular, an insurer must not introduce any of the following practices, although it may continue using accounting policies that involve them (para 25):

(a) measuring insurance liabilities on an undiscounted basis;

(b) measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current market-based fees for similar services;

(c) using non-uniform accounting policies for the insurance liabilities of subsidiaries.

Further, HKFRS 4 specifically states that an insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence (para 26). However, if an insurer already measures its insurance contracts with sufficient prudence, it should not introduce additional prudence.

There is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts (para 27). When an insurer changes its accounting policies for insurance liabilities, it may reclassify some or all financial assets "at fair value through profit or loss".

Other issues addressed by HKFRS 4 include the following.

(a) An insurer need not account for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract (para 7).

(b) An insurer is required to unbundle (i.e. account separately for) deposit components of some insurance contracts (e.g. a profit sharing reinsurance contract where the cedant is guaranteed a minimum repayment of its premium) (para 10).

(c) An insurer may apply "shadow accounting" (i.e. account for both realised and unrealised gains or losses on assets in the same way relative to measurement of insurance liabilities) (para 30).

(d) An insurer is permitted to use an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer (para 31).

(e) Discretionary participation features contained in insurance contracts or financial instruments may be recognised as a liability or as a separate component of equity (para 35).

¶12-400 Disclosures

Enhanced disclosures are required in HKFRS 4 and they are described below. HKFRS 4 requires an insurer to disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts (para 36).

To provide information that helps users understand the recognised amounts in the insurer's financial statements arising from insurance contracts, HKFRS 4 requires an insurer to disclose the following (para 37):

(a) its accounting policies for insurance contracts and related assets, liabilities, income, and expense;

(b) the recognised assets, liabilities, income, expense, and cash flows arising from insurance contracts. If the insurer is a cedant, it shall disclose—

- gains and losses recognised in profit or loss on buying reinsurance; and
- if the cedant defers and amortises gains and losses arising on buying reinsurance, the amortisation for the period and the amounts remaining unamortised at the beginning and end of the period.

(c) the process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts described in (b), if practicable, quantified disclosure of those assumptions shall be given;

(d) the effect of changes in assumptions used to measure insurance assets and insurance liabilities;

(e) reconciliations of changes in insurance liabilities, reinsurance assets, and, if any, related deferred acquisition costs.

HKFRS 4 also requires an insurer to disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts (para 38).

Specifically, HKFRS 4 requires an insurer to disclose the following (para 39):

(a) its risk management objectives, policies and processes, and the methods used to manage risks arising from insurance contracts;

(b) those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of the insurer's future cash flows;

(c) information about insurance risk (both before and after risk mitigation by reinsurance), including information about—

- sensitivity to insurance risk;
- concentrations of insurance risk, including a description of how management determines concentrations and a description of the shared characteristic that identifies each concentration;
- actual claims compared with previous estimates, going back to the period, but not more than 10 years, when the earliest material claims arose for which there is still uncertainty about the amount and timing of the claims payment;

(d) information about credit risk, liquidity risk and market risk that HKFRS 7 would require if the insurance contracts were within the scope of HKFRS 7; and

(e) information about exposures to market risk arising from embedded derivatives contained in a host insurance contract if the insurer does not measure the embedded derivatives at fair value.

To comply with para 39(c)(i), an insurer shall disclose either (a) or (b) below (para 39A):

(a) a sensitivity analysis that shows how profit or loss and equity would have been affected if there been changes in the relevant risk variable that were reasonably possible at the end of the reporting period had occurred; the

When retrospective application is impracticable, the transitional requirements would be applied at the beginning of the earliest period practicable, e.g. the date control was deemed to be obtained or lost (para C4A and C5A).

Two illustrations follow to further explain the principles involved with regard to comparative period reporting:

Illustration 18.6 — Investee consolidated upon application of HKFRS 10

P Ltd has a financial interest in Z Ltd (a trading company); it does not consolidate Z Ltd currently. P Ltd's financial year ends on 31 December and presents one year of comparatives. P Ltd assesses the need to consolidate Z Ltd in accordance with HKFRS 10 from 1 January 2013, its date of initial application of HKFRS 10, and concludes Z Ltd should be consolidated.

P Ltd should follow these steps:

(a) It determines that if HKFRS 10 had been effective at the date of acquisition, P Ltd would have obtained control of Z Ltd at that date.

(b) P Ltd measures Z Ltd's assets, liabilities and NCI according to HKFRS 3 and determines goodwill as of the acquisition date.

(c) P Ltd then determines the carrying amounts of Z Ltd's net assets and NCI as of 1 January 2012 as if Z Ltd had been previously consolidated.

(d) The difference between the currently determined carrying amount and the existing carrying amount in Z Ltd at 1 January 2012 is recognised in retained earnings at that date.

Illustration 18.7 — Investee deconsolidated upon application of HKFRS 10

P Ltd has a financial interest in S Ltd (a trading company); it consolidates S Ltd at present. P Ltd's financial year ends on 31 December and presents one year of comparatives. P Ltd assesses whether S Ltd would be consolidated under HKFRS 10 from 1 January 2013, its date of initial application of HKFRS 10, and concludes S Ltd would not be consolidated.

P Ltd should follow these steps:

(a) It determines that if HKFRS 10 had been effective, control would have been lost on 5 October 2010.

(b) P Ltd accounts for the loss of control of S Ltd and measures its interest as of 5 October 2010 per HKFRS 10.

(c) P Ltd measures its interest in S Ltd as of 1 January 2012 in accordance with the relevant HKFRS.

(d) The difference between the currently determined carrying amount of S Ltd and the existing consolidated carrying amount at 1 January 2012 is recognised in retained earnings at that date.

¶18-600 Investment entities: exception to consolidation

HKFRS 10 provides an exception for investment entities from the existing requirement to consolidate such subsidiaries. An investment entity shall measure an investment in a subsidiary at fair value through profit or loss in accordance with HKFRS 9 "Financial Instruments" (para 31).

A parent shall determine whether an entity is an investment entity. Investment entity is defined as an entity that (Appendix A and para 27):

(a) obtains funds from one or more investors for the purpose of providing those investors with investment management services;

(b) commits to its investors that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and

(c) measures and evaluates the performance of substantially all of its investments on a fair value basis.

Entities should also consider whether they contain the typical characteristics of an investment entity, including multiple investments and investors, non-related party investors, and ownership interests in the form of equity or similar interests (para 28). While these characteristics are not conclusive, an investment entity lacking such characteristics will be required to disclose the reasons it should be considered as an investment entity (para 28).

An investment entity will account for its portfolio investments at fair value, even if it has a significant influence in the investee. However, HKFRS 10 does not permit an exception for a non-investment entity parent with a controlling interest in an investment entity to consolidate that entity. Instead, the non-investment parent must consolidate all entities that it controls, including those controlled through an investment entity subsidiary (para 33).

¶18-700 Comparison with International Financial Reporting Standards

HKFRS 10 is based on IFRS 10 "Consolidated Financial Statements". There are no major textual differences between HKFRS 10 and IFRS 10. Compliance with HKFRS 10 will ensure compliance with IFRS 10.

19 Preparation of Consolidated Financial Statements

¶19-100 Introduction

The preparation and presentation of consolidated financial statements are governed by the requirements of HKFRS 10 "Consolidated Financial Statements" and HKFRS 3 "Business Combinations".

¶19-200 Requirements of HKFRS 10

Consolidated financial statements are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity (Appendix A).

HKFRS 10 requires every entity, except a parent described in para 4(a), to present consolidated financial statements (para 4).

Under para 4(a), a parent need not present consolidated financial statements if it meets all the following conditions:

(a) it is itself a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

(b) its debt or equity instruments are not traded in a public market;

(c) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

(d) its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with HKFRS or International Financial Reporting Standards.

In the consolidation process, HKFRS 10 provides for the following:

(a) Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances (para 19);

(b) The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements should have the same reporting date (para B92). When the end of the reporting period of the parent is different from that of a subsidiary, for consolidation purposes, additional financial statements as of the same date as the financial statements of the parent should be prepared unless it is impracticable to do so (para B92);

(c) If it is impracticable to do so, the parent should consolidate the financial information of the subsidiary using the most recent financial statements of the subsidiary adjusted for the effects of significant transactions or events that occur between the date of those financial statements and the date of the consolidated financial statements. In any case, the difference between the date of the subsidiary's financial statements and that of the consolidated financial statements should not exceed three months (para B93);

(d) Intra-group transactions and balances should be eliminated in full (para B86(c));

To illustrate, P Ltd gives a loan of $1,000,000 to its subsidiary, S Ltd. In their respective statements of financial position, P Ltd correctly carries a loan receivable account, and S Ltd correctly carries a loan payable account. However, in the consolidated financial statements, where P Ltd and S Ltd are treated as a single economic entity, it does not make sense to show that the entity borrows from or lends to itself. Thus, in the consolidation process, the intra-group balances (that is, the intra-group loan payable and receivable) of $1,000,000 should be eliminated in full;

(e) Intra-group transactions and the resulting unrealised profits should be eliminated in full (para 86(c));

To illustrate, P Ltd sells a piece of goods, carried in its books at $100,000, to its 80%-held subsidiary for $150,000. If the piece of goods is still held within the group, the profit of $50,000 reported in P Ltd's books is said to be "unrealised" and therefore has to be eliminated during the consolidation process. HKFRS 10 requires that the unrealised profit be eliminated in full, regardless of the percentage of interest P Ltd holds in S Ltd;

Also, at group level, the piece of goods that is carried in S Ltd's books at $150,000 should be reverted to the original cost to the group of $100,000;

(f) Unrealised losses resulting from intra-group transactions should also be eliminated unless there is an indication of an impairment that requires recognition in the consolidated financial statements (para 86(c));

To illustrate, P Ltd has a piece of goods purchased at a cost of $100,000 which is partly damaged and is deemed to have a net realisable value of $80,000. If it sells the goods to its subsidiary for $80,000, the loss of $20,000 resulting from the intra-group transaction in this case should not be eliminated. The goods should be carried in the consolidated financial statements at $80,000;

However, if in the above case, the piece of goods is not damaged and has a net realisable value which is higher than cost, the unrealised loss of $20,000 should be eliminated at group level;

(g) Non-controlling interest should be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent (para 22). Non-controlling interest in the consolidated statement of comprehensive income should also be presented separately (see HKAS 1 "Presentation of Financial Statements");

(h) Profit or loss and each component of other comprehensive income are attributed to the owners of the parents and to non-controlling interests even if this results in the non-controlling interests having a deficit balance (para B94).

To illustrate, P Ltd acquires 90% of S Ltd on 1 January 20x9. At this date, S Ltd's net identifiable assets are represented by a share capital of $10,000,000. For the year ended 31 December 20x9, S Ltd reports a loss and total comprehensive expense of $15,000,000. In this case, the loss and total comprehensive expense attributable to the non-controlling interest of $1,500,000 exceeds the non-controlling interest in the equity of S Ltd of $1,000,000, and results in non-controlling interest being carried in the consolidated statement of financial position with a debit balance.

(i) The income and expenses of a subsidiary are included in the consolidated financial statements from as from the acquisition date. In other words, only the post-acquisition profits of the subsidiary are included in the consolidated financial statements; the pre-acquisition profits of the subsidiary are eliminated (para B88);

To illustrate, P Ltd acquires 100% of S1 Ltd on 30 April 20x9. In this case, the profit of S1 Ltd that is to be included in the consolidated statement of comprehensive income for the year ended 31 December 20x9 is the profit made by S1 Ltd during the period 1 May 20x9 to 31 December 20x9;

P Ltd also acquires 100% of S2 Ltd in 20x6 when S2 Ltd's retained profit is $100,000. If S2 Ltd's retained profit is $300,000 on 31 December 20x9, the amount of S2 Ltd's retained profit to be included in the retained profit in the consolidated statement of financial position as at 31 December 20x9 is the post-acquisition profit of $200,000 ($300,000 – $100,000).

¶19-300 Requirements of HKFRS 3

Since most of the business combinations resulting in a need for consolidated financial statements are in the nature of "acquisitions", the following provisions of the HKFRS 3 relating to the acquisition method of consolidation accounting should be noted:

(a) the identifiable assets acquired and liabilities assumed of the subsidiary should be recognised and measured based on their respective fair value as at the acquisition date in the consolidated financial statements;

(b) goodwill should be recognised as an asset and subject to impairment, but not subject to amortisation;

(c) bargain purchase gain should be recognised immediately in profit or loss;

(d) non-controlling interest in the consolidated statement of financial position should be measured based on:

(i) fair value (e.g. market value of shares); or

(ii) the fair values of the net identifiable assets of the subsidiary.

Please refer to the Chapter on HKFRS 3 for illustrations of the above issues.

¶19-400 Basic consolidation issues

The most fundamental consolidation process is to combine the financial statements of the parent and subsidiary together into one set of financial statements — the consolidated financial statements. This will be discussed below under ¶19-410 "Combination of financial statements".

A consolidation issue arises if the identifiable assets and liabilities of the subsidiary acquired are not stated at their respective fair values. This could happen if some of the subsidiary's assets and liabilities are undervalued, overvalued or not recognised. This issue is dealt with in the commentary under ¶19-420 "Subsidiary's assets and liabilities acquired".

Another consolidation issue that may be encountered is when the cost of investment is not equal to the fair value of the net identifiable assets of the subsidiary acquired. The difference could be because the subsidiary has a non-identifiable asset (e.g. goodwill), or because the parent is willing to pay a premium for the benefits of the affiliation (e.g. economies of scale, reduction of risks, etc); the reverse may also happen. This issue is discussed further in the commentary under ¶19-430 "Goodwill on consolidation".

A further consolidation issue arises if the parent does not acquire 100% of the subsidiary's issued share capital. In this case, a non-controlling interest (i.e. the interest of the non-controlling shareholders in the net assets of subsidiary) will arise. This problem will be dealt with in the commentary under ¶19-440 "Non-controlling interest".

In the preparation of consolidated financial statements subsequent to the acquisition date, several additional issues are encountered.

Firstly, in addition to the consolidated statement of financial position, the consolidated statement of comprehensive income has to be prepared because the parent and subsidiary have operated as an economic group during the periods subsequent to the acquisition date. The preparation of the consolidated statement of comprehensive income is discussed in isolation in the commentary under ¶19-450 "Consolidated statement of comprehensive income" and later dealt with together with the preparation of the consolidated statement of financial position.

Secondly, the reserves in the statement of financial position of the subsidiary as at a date subsequent to the acquisition date must be apportioned, from the group's viewpoint, into two distinct parts: the portion that had existed before the subsidiary was acquired and the portion that has arisen after the subsidiary was acquired. The reserves of the subsidiary at the acquisition date are referred to as "pre-acquisition reserves", and those that have arisen since the acquisition date are referred to as "post-acquisition reserves". The significance of this distinction and the consolidation treatment of pre-acquisition reserves and post-acquisition reserves are discussed in the commentary under ¶19-460 "Pre-acquisition and post-acquisition reserves".

Subsequent to the acquisition date, there could be transactions among the entities in the group. This would give rise to several issues for the consolidation process. These issues are discussed in the commentary under ¶19-470 "Intra-group accounts" and ¶19-480 "Unrealised intra-group profits and losses".

Further, there may be changes in the parent's shareholding interest in its subsidiary. This issue is discussed in the commentary under ¶19-490 "Disposal of interests in a subsidiary".

A comprehensive illustrative example to round up the discussion on the basic consolidation issues is presented in the Appendix of this chapter.

¶19-410 Combination of financial statements

In this section, it is assumed that:

(a) the parent acquires 100% of the subsidiary's issued share capital and obtains control of the subsidiary;

(b) the net identifiable assets of the subsidiary are stated at their respective fair values; and

(c) the cost of investment is equal to the fair value of the net identifiable assets of the subsidiary acquired at the acquisition date.

This is the simplest case of a consolidation problem. All that is required in the consolidation process is to:

(a) eliminate the "cost of investment" against the "shareholders' equity of subsidiary"; and

(b) add together, on a line-by-line basis, like items of assets and liabilities in the statements of financial position of the parent and subsidiary.

It is necessary to eliminate the cost of investment against the shareholders' equity of subsidiary because at the acquisition date the cost of investment is equal to the net assets of the subsidiary acquired. Moreover, the net assets of the subsidiary are represented by its shareholders' equity (i.e. assets – liabilities = equity). The elimination will avoid double counting when all the assets and liabilities of the parent and subsidiary are added together.

The net effect is to replace the "cost of investment" in the parent's statement of financial position with the assets and liabilities of the subsidiary. Thus, the consolidated statement of financial position will show, as it should, that all the assets and liabilities of both the parent and the subsidiary are under common control.

Illustration 19.1

P Ltd acquired 100% of the issued share capital of S Ltd on 31 December 20x8 and obtained control of S Ltd for a total consideration of $150,000. The statements of financial position of P Ltd and S Ltd as at that date, which reflect the fair values of the respective net identifiable assets, are as follows:

	P Ltd	*S Ltd*
	$'000	*$'000*
ASSETS		
Non-current assets		
Land	500	100
Investment in S Ltd	150	—
Current assets		
Trade receivables	100	—
Bank	50	100
Total assets	800	200
EQUITY AND LIABILITIES		
Equity		
Share capital	500	100
Retained profit	200	50
Total equity	700	150
Non-current liabilities		
Long-term loan	—	50
Current liabilities		
Trade payables	100	—
Total equity and liabilities	800	200

Required:

Prepare the consolidated statement of financial position for P Ltd and its subsidiary as at 31 December 20x8.

Solution:

(I) Consolidation journal entry

		$'000	$'000
Dr	Share capital (S)	100	
Dr	Retained profit (S)	50	
Cr	Investment in S Ltd		150

(to eliminate Investment in subsidiary account)

(II) Consolidation worksheet

	P Ltd	*S Ltd*	*Adjustments*		*Consolidated balances*
			Dr	*Cr*	
	$'000	*$'000*	*$'000*	*$'000*	*$'000*
Land	500	100			600
Investment in S Ltd	150	—		150	—
Trade receivables	100	—			100
Bank	50	100			150
Share capital	500	100	100		500
Retained profit	200	50	50		200
Long-term loan	—	50			50
Trade payables	100	—			100

30 HK(IFRIC)-Int 7

"Applying the Restatement Approach under HKAS 29 Financial Reporting in Hyperinflationary Economies"

¶30-100 Introduction

HKAS 29 "Financial Reporting in Hyperinflationary Economies" requires that the financial statements of an entity that reports in the currency of a hyperinflationary economy should be stated in terms of the measuring unit current at the end of the reporting period. Comparative figures for prior period(s) should be restated into the same current measuring unit.

The restatement of financial statements in accordance with HKAS 29 may give rise to differences between the carrying amount of individual assets and liabilities in the statement of financial position and their tax bases. These differences are accounted for in accordance with HKAS 12 "Income Taxes" (HKAS 29, para 32).

HK(IFRIC)-Int 7 "Applying the Restatement Approach under HKAS 29 Financial Reporting in Hyperinflationary Economies" provides guidance on how an entity would restate its financial statements in accordance with HKAS 29 in the first year it identifies the existence of hyperinflation in the economy of its functional currency, especially with respect to the calculation of opening deferred tax items.

¶30-200 Issues

The issues addressed in HK(IFRIC)-Int 7 are (para 2):

(a) How should the requirement "…stated in terms of the measuring unit current at the end of the reporting period date" in para 8 of HKAS 29 be interpreted?

(b) How should the opening deferred tax items be accounted for in the restated financial statements?

¶30-300 Conclusions

HK(IFRIC)-Int 7 requires that in the year in which an entity identifies the existence of hyperinflation in the economy of its functional currency, the entity shall apply the "restatement approach" under HKAS 29 as if the economy had always been hyperinflationary (para 3).

On the first issue, HK(IFRIC)-Int 7 provides that the entity's opening statement of financial position at the beginning of the earliest period presented in the financial statements shall be restated as follows (para 3):

(a) non-monetary items carried at historical cost are restated to reflect the effect of inflation from the date the assets were acquired and the liabilities were incurred or assumed until the end of the current reporting period; and

(b) non-monetary items carried at revalued amounts or fair values (for example, property, plant and equipment using the revaluation model under HKAS 16 "Property, Plant Equipment") shall reflect the effect of inflation and restated from the dates those carrying amounts were determined until the end of the current reporting period.

Illustration 30.1

ABC Ltd bought a piece of land for $100 million and some equipment for $100 million on 31 December 20x1.

The land is revalued to $120 million on 31 December 20x3.

The equipment is carried at cost less accumulated depreciation.

The equipment is depreciated using the straight-line method over 10 years with no residual value.

The general price indices are as follows:

At 31 December 20x1: 100

At 31 December 20x2: 110

At 31 December 20x3: 130

At 31 December 20x4: 260

In the original 2004 statement of financial position, the land and the equipment were presented as follows:

	31 December 20x4	31 December 20x3
Land	$120 million	$120 million
Equipment	$70 million	$80 million

For the restatement under HKAS 29, HK(IFRIC)-Int 7 requires the following calculations:

(a) Land

As at 31 December 20x3: $120 million × 260/130 = $240 million

As at 31 December 20x4: $120 million × 260/130 = $240 million

(b) Equipment

As at 31 December 20x1: $100 million × 260/100 = $260 million

Depreciation for 20x2: $10 million × 260/100 = $26 million

As at 31 December 20x2: $260 million − $26 million = $234 million

Depreciation for 20x3: $10 million × 260/100 = $26 million

As at 31 December 20x3: $260 million − $52 million = $208 million

Depreciation for 20x4: $10 million × 260/100 = $26 million

As at 31 December 20x4: $260 million − $78 million = $182 million(* This figure may also be arrived at as follows: $70 million × 260/100)

Thus, in the restated 20x4 statement of financial position, the land and the equipment will be as follows:

	31 December 20x4	31 December 20x3
Land	$240 million	$240 million
Equipment	$182 million	$208 million

Deferred tax items are recognised and measured in accordance with HKAS 12 at the end of the reporting period (para 4). However, in calculating deferred tax items in the opening statement of financial position, HK(IFRIC)-Int 7 requires that the nominal carrying amounts of non-monetary items in the opening statement of financial position are firstly restated by applying the measuring unit at that date. The deferred tax items remeasured in this way are then restated for the change in the measuring unit from the date of the opening statement of financial position of the reporting period to the end of that reporting period (para 4).

Illustration 30.2

Refer to ABC Ltd in Illustration 30.1 above.

Assume that in its original 20x4 statement of financial position, ABC Ltd has the following additional deferred tax liability:

	31 December 20x4	31 December 20x3
Deferred tax liability	$10 million	$8 million

The deferred tax liabilities above arose because of the taxable temporary difference between the carrying amount and the tax base of the equipment and assumed a tax rate of 20%, as follows:

	31 December 20x4	31 December 20x3
Carrying amount	$70 million	$80 million
Tax base	$20 million	$40 million
Taxable temporary difference	$50 million	$40 million
Tax rate of 20%		
Deferred tax liability	$10 million	$8 million

However, due to the restatement of equipment to $182 million as at 31 December 20x4 (see Illustration 30.1 above), the temporary difference will now be $162 million (carrying amount of $182 million less tax base of $20 million), and the deferred tax liability should be $32.4 million ($162 million × 20%).

As for the 20x3 statement of financial position, the restated carrying amount of the equipment as at 31 December 20x3 is $104 million ($80 million × 130/100), giving rise to a temporary difference of $64 million (carrying amount of $104 million less tax base of $40 million). Consequently, the deferred tax liability as at 31 December 20x3 should be $12.8 million ($64 million × 20%).

Presented as comparative figure for 20x4 statement of financial position, the 20x3 deferred tax liability will be restated to $25.6 million ($12.8 million × 260/130).

Thus, in the restated 20x4 statement of financial position, the deferred tax liability will be as follows:

	31 December 20x4	31 December 20x3
Deferred tax liability	$32.4 million	$25.6 million

HK(IFRIC)-Int 7 further provides that after an entity has restated its financial statements, all corresponding figures in the financial statements for a subsequent reporting period are restated by applying the change in the measurement unit for that subsequent reporting period to the restated financial statements for the previous reporting period only (para 5).

¶30-400 Comparison with IFRIC-Int 7

HK(IFRIC)-Int 7 is based on IFRIC-Int 7 "Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies". There are no significant differences between HK(IFRIC)-Int 7 and IFRIC-Int 7. Compliance with HK(IFRIC)-Int 7 will ensure compliance with IFRIC-Int 7.

31 HK(IFRIC)-Int 8

"Scopes of HKFRS 2"

¶31-100 Introduction

HKFRS 2 "Share-based Payment" applies to share-based payment transactions in which the entity receives or acquires goods or services. There is an underlying presumption that an entity is able to identify the goods and services received. However, in some situations, it might be difficult to demonstrate that the entity has received or acquired identifiable goods or services. For example, an entity may grant shares to a charitable organisation for nil consideration. This raises the question of whether HKFRS 2 applies to such transactions. HK(IFRIC)-Int 8 provides guidance to this issue.

HK(IFRIC)-Int 8 was subsequently superseded by the Amendment to HKFRS 2 "Share-based Payment — Group Cash-settled Share-based Payment Transactions" which the amended provisions have been incorporated in HKFRS 2 "Share-based Payment".

¶31-200 Issues

The main issue addressed in HK(IFRIC)-Int 8 is whether HKFRS 2 applies to transactions in which the entity cannot identify specifically some or all of the goods or services received (para 7).

HK(IFRIC)-Int 8 also addresses the issue of how such unidentifiable goods and services received should be measured.

¶31-300 Conclusions

HK(IFRIC)-Int 8 concludes that HKFRS 2 applies to particular transactions in which goods or services are received, including transactions in which the entity cannot identify specifically some or all of the goods or services received (para 8).

HK(IFRIC)-Int 8 also concludes that in the absence of specifically identifiable goods or services, other circumstances may indicate that goods or services have been (or will be) received, in which case HKFRS 2 applies. If the identifiable consideration received (if any) appears to be less than the fair value of the equity instruments granted or liability incurred, it is presumed that other consideration (i.e. unidentifiable goods or services) has been (or will be) received (para 9).

5% per annum, ABC Ltd has assigned $7,800,000 of the proceeds to the debt component, and $2,200,000 to equity component of the convertible bond. The tax authority does not allow ABC Ltd to claim any deduction for the imputed discount on the convertible bond. The tax rate is 25%.

In the above case, there is a taxable temporary difference of $2,200,000 as at 31 December 20x1. Based on the tax rate of 25%, ABC Ltd will have to recognise a deferred tax liability of $550,000 in other comprehensive income.

The journal entries to record the issuance of the convertible loan on 31 December 20x1 will be as follows:

Dr	Cash	7,800,000	
Dr	Bond discount	2,200,000	
Cr	Bond payable		10,000,000
	(to record the debt component)		
Dr	Cash	2,200,000	
Cr	Deferred tax liability		550,000
Cr	Capital reserve		1,650,000
	(to record the equity component and the related tax effect)		

For the year ended 31 December 20x2, ABC Ltd will amortise the bond discount, using the effective interest method, which will yield an interest expense of $390,000 ($7,800,000 × 5%).

The amortisation of the bond discount will reduce the temporary difference to $1,810,000 ($2,200,000 – $390,000), and the deferred tax liability to $452,500 ($1,810,000 × 25%) as at 31 December 20x2.

The interest expense and the related tax effect for the year 20x2 will be recorded s follows:

Dr	Interest expense	390,000	
Cr	Bond discount		390,000
Dr	Deferred tax liability (452,500 – 550,000)	97,500	
Cr	Tax expense		97,500

¶51-260 Temporary differences arising on investments in subsidiaries, associates and branches, and interests in joint arrangements

Temporary differences arise when the carrying amount of investments in subsidiaries, associates and branches, and interests in joint arrangements becomes different from the tax base (which is often cost) of the investment or interest. Such differences may arise due to, for example:

(a) the existence of undistributed profits of subsidiaries, associates, branches and joint arrangements;

(b) changes in the foreign exchange rates (when the investee is located in a foreign country); or

(c) a reduction in the carrying amount of an investment or interest to its recoverable amount.

HKAS 12 provides that an entity shall recognise a deferred tax liability for all taxable temporary differences arising from the investment or interest, except to the extent that (para 39):

(a) the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and

(b) it is probable that the temporary difference will not reverse in the foreseeable future.

HKAS 12 also provides that an entity shall recognise a deferred tax asset for all deductible temporary differences arising from the investment in subsidiaries, associates and branches, and interests in joint arrangements, to the extent that (para 44):

(a) it is probable that the temporary difference will reverse in the foreseeable future; and

(b) taxable profit will be available against which the temporary difference can be utilised.

Under the above provisions, an entity would generally not have to recognise the deferred tax liability on the temporary differences arising from undistributed profits retained in a subsidiary (the dividend policy of which is under the control of the entity) if the entity has determined that those profits will not be distributed in the foreseeable future. On the other hand, since an entity does not have control over the dividend policy of an associate, the entity would have to recognise the deferred tax liability on the temporary differences arising from undistributed profits retained in an associate.

However, under the Hong Kong tax rules, there is no tax payable on dividend received. Therefore, applying the first principle, deferred tax liability need not be accounted for in relation to the temporary differences arising from undistributed profits retained in subsidiaries and associates, in the Hong Kong context.

¶51-270 A further example

A further illustration on the issues discussed so far is presented below:

Illustration 51.20

ABC Ltd commenced operation in January 20x7 and its statement of financial position as at 31 December 20x7 showed the following:

(a) cost of non-current assets of $3,465,000 less accumulated depreciation of $493,000;

(b) allowance for doubtful debts of $200,000; and

(c) provision for warranty of $100,000.

The notes show that the cost and accumulated depreciation of the non-current assets consist of the following:

	Cost	Accumulated depreciation
	$'000	*$'000*
Land	1,000	—
Plant and machinery	2,465	493
Total	3,465	493

The tax written down value of the non-current assets (excluding land) is $1,500,000.

Assume that there are no other temporary differences as at 31 December 20x7.

In this case, the deferred tax liability as at 31 December 20x7 may be computed as follows (assuming a tax rate of 25%):

		$'000
Non-current assets		
Cost		
per statement of financial position		3,465
Less: Land		1,000
		2,465
Accumulated depreciation		
per statement of financial position		493
Carrying amount		1,972
Tax base (tax written down value)		1,500
Taxable temporary differences	482	
Allowance for doubtful debts		
Carrying amount		200
Tax base		—
Deductible temporary differences	(200)	
Provision for warranty		
Carrying amount		100
Tax base		—
Deductible temporary differences	(100)	
Net taxable temporary differences		172
Deferred tax liability (172 × 25%)		43

For purposes of discussion, the case of ABC Ltd above is extended to the year 20x8.

Assume that during the year 20x8, the following were charged to profit or loss of ABC Ltd:

(a) depreciation expenses of $96,000;

(b) allowance for doubtful debts of $70,000; and

(c) provision for warranty of $nil.

However, for tax purposes, the following items were deductible:

(a) capital allowances of $200,000;

(b) actual bad debt of $60,000; and

(c) actual warranty expenses of $40,000.

Further, ABC Ltd revalued its land to the market value of $1,200,000 as at 31 December 20x8. Assume that the gain on the sale of land will attract tax at a rate of 25%.

Assuming there were no other movements for the relevant accounts, ABC Ltd's statement of financial position as at 31 December 20x8 will show the following balances:

(a) cost of non-current assets of $3,665,000 ($3,465,000 + revaluation of $200,000) less accumulated depreciation of $589,000 ($493,000 + $96,000);

(b) allowance for doubtful debts of $210,000; and

(c) provision for warranty of $60,000.

The notes show that the cost and accumulated depreciation of the non-current assets consist of the following:

	Cost $'000	Accumulated depreciation $'000
Land	1,200	—
Plant and machinery	2,465	589
Total	3,665	589

The tax written down value of non-current assets (excluding land) will be $1,300,000 ($1,500,000 – $200,000).

With the information given above, the deferred tax liability as at 31 December 20x8 may be determined as follows:

	$'000
Non-current assets	
Cost	
per statement of financial position	3,665
Less: Land	1,200
	2,465
Accumulated depreciation	
per statement of financial position	589
Carrying amount	1,876
Tax base (tax written down value)	1,300
Taxable temporary differences	576
Land	
Carrying amount	1,200
Tax base	1,000

	$'000
Taxable temporary differences	200
Allowance for doubtful debts	
Carrying amount	210
Tax base	—
Deductible temporary differences	(210)
Provision for warranty	
Carrying amount	60
Tax base	—
Deductible temporary differences	(60)
Net taxable temporary differences	506
Deferred tax liability (506 × 25%)	126.5

Given that the deferred tax liability as at 31 December 20x7 was $43,000, it should be increased (credited) by $83,500 to arrive at the balance of $126,500 to be shown in the statement of financial position as at 31 December 20x8.

Of the $83,500 increase in the deferred tax liability for the year 20x8, $50,000 which relates to the revaluation surplus should be recognised in other comprehensive income, and the remaining $32,500 charged to profit or loss.

The journal entry (ignoring tax payable) required is as follows:

*Dr	Revaluation surplus	50,000	
Cr	Deferred tax liability		50,000
Dr	Tax expense	33,500	
Cr	Deferred tax liability		33,500

* This journal entry is based on the assumption that the revaluation of land was initially recorded as follows:

Dr	Land	200,000	
Cr	Revaluation surplus		200,000

Alternatively, the journal entries could be combined as follows:

Dr	Land	200,000	
Cr	Deferred tax liability		50,000
Cr	Revaluation surplus		150,000

¶51-280 Loss carried forward

The *Inland Revenue Ordinance* provides that losses incurred in one period may be carried forward to subsequent periods (sec 19C(4)).

However, sec 61B provides that the losses may be disregarded unless the Commissioner of Inland Revenue is satisfied that the shareholders have remained substantially the same over the years.

It should be noted that there is no limit to the time period for which the losses can be carried forward.

It should also be noted that the *Inland Revenue Ordinance* does not provide for carrying back of tax losses. Therefore, it should be noted that para 13 of HKAS 12 is, therefore, not applicable in Hong Kong.

The following illustrates the provision of sec 19C(4) of the *Inland Revenue Ordinance*.

Illustration 51.21

A Ltd suffered a loss of $100,000 in 20x5, and made a profit of $300,000 in 20x6 (assuming no temporary differences and therefore the accounting profit or loss is equal to tax profit or loss).

For 20x5, A Ltd would have no tax payable because there was no taxable profit.

For 20x6, A Ltd would have a taxable profit of $200,000, after offsetting the tax loss of $100,000 carried forward from 20x5 against the profit of $300,000 in 20x6. Assuming a tax rate of 25%, A Ltd would have a tax payable of $50,000.

It may be noted that, without the loss in 20x5, A Ltd would have a tax payable of $75,000 ($300,000 × 25%) instead of $50,000 in 20x6. The tax loss of $100,000 in 20x5 gives rise to a tax saving of $25,000 in 20x6.

It may be appreciated, however, that if A Ltd does not make any profit in all the years subsequent to 20x5 before it is wound up, then the benefit relating to the tax loss of $100,000 in 20x5 will never be realised.

Thus, there is a benefit relating to the tax loss but the realisation of the benefit is contingent upon sufficient income being made in subsequent periods.

How this potential tax saving relating to a tax loss carried forward (and the related deferred tax asset) shall be accounted for is the topic of discussion in this section.

(It may be noted that the accounting for unabsorbed loss carried forward discussed in this section is equally applicable to that for unutilised capital allowances.)

HKAS 12 provides that a deferred tax asset shall be recognised for loss carried forward to the extent that it is probable that future taxable profit will be available against which the loss carried forward can be utilised (para 34). To the extent that it is not probable that future taxable profit will be available against which the loss carried forward can be utilised, the deferred tax asset is not recognised (para 36).

It may be noted that HKAS 12 is rather liberal in allowing the tax benefit (and the related deferred tax asset) of tax loss to be recognised in the year of loss.

In considering whether "it is probable that future taxable profit will be available against which the loss carry-forward can be utilised", HKAS 12 requires an entity to take the following circumstances into consideration (para 36):

(a) whether the entity has sufficient taxable temporary differences relating to the same tax authority and the same taxable entity, which will result in taxable amount against which the loss carried forward can be utilised before it expires;

(b) whether it is probable that the entity will have taxable profit before the loss carried forward expires;

(c) whether the loss carried forward results from identifiable causes which are unlikely to recur; and

(d) whether tax planning opportunities are available to the entity which will create taxable profit in which the loss carried forward can be utilised.

HKAS 12 also cautions that the existence of unused tax losses is strong evidence that future taxable profit may not be available (para 35).

The following is an illustration for a case under para 34 where deferred tax asset is recognised for loss carried forward to the extent that it is probable that future taxable profit will be available against which the loss carried forward can be utilised.

Illustration 51.22

A Ltd commenced operation in 20x1 and has been operating profitably. It suffered a loss of $100,000 in 20x5 due to labour disputes. (Assume there were no temporary differences such that the accounting loss is equal to tax loss, and a tax rate of 25%.) The labour dispute has been settled towards the end of 20x5, and the company is expected to operate profitably again in year 20x6 and beyond.

In this case, it may be probable that future taxable profit will be available against which the loss carried forward can be utilised, and para 34 is applicable.

Applying the provision of para 34, a deferred tax asset in relation to the loss and the related tax benefit is recognised in 20x5.

The journal entries for 20x5 will be as follows:

Dr	Deferred tax asset	25,000	
Cr	Tax credit		25,000
	(to record tax saving related to the loss of $100,000 for the year)		

Assume that A Ltd made a profit of $300,000 for the year ended 31 December 20x6. (Assume further there were no temporary differences such that the accounting loss is equal to tax loss, and a tax rate of 25%.)

The journal entries for 20x6 will be as follows:

Dr	Tax expense	75,000	
Cr	Tax payable		75,000
	(to record tax payable on profit of $300,000 for the year)		
Dr	Tax payable	25,000	
Cr	Deferred tax asset		25,000
	(to record utilisation of loss carried forward)		

The above entries could, in fact, be combined as follows:

Dr	Tax expense	75,000	
Cr	Deferred tax asset		25,000
Cr	Tax payable		50,000
	(to record tax for the year)		

The relevant accounts will be shown in the 20x5 and 20x6 financial statements of A Ltd as follows:

Statements of comprehensive income

	20x5	20x6
	$'000	*$'000*
Profit/(loss) before tax	(100)	300
Tax expense/(credit)	(25)	75
Profit/(loss) after tax	(75)	225

Statements of financial position

	20x5	20x6
	$'000	*$'000*
Asset		
Deferred tax asset	25	—
Liability		
Tax payable	—	50

(Note that, in financial accounting, the term "tax credit" is simply the opposite of "tax expense"; it does not carry the same meaning as the term "tax credit" under the *Inland Revenue Ordinance*.)

The following is an illustration for a case under para 36 where it is not probable that future taxable profit will be available against which the loss carried forward can be utilised and, consequently, the deferred tax asset is not recognised.

Illustration 51.23

B Ltd commenced operation in January 20x5, and suffered a loss of $100,000 for the year ended 31 December 20x5. (Assume there were no temporary differences such that the accounting loss is equal to tax loss, and a tax rate of 25%.)

In this case, it cannot be argued that it is probable for future taxable profit to be available against which the loss carried forward can be utilised, and therefore para 36 is applicable.

Under para 36, no deferred tax asset (and related tax benefit) is recognised in 20x5. The tax saving relating to the $100,000 loss in 20x5 is accounted for only in the years in which it is realised.

Assume that B Ltd made a profit of $300,000 for the year ended 31 December 20x6. (Assume further there were no temporary differences such that the accounting loss is equal to tax loss, and a tax rate of 25%.) In this case, the tax saving relating to the $100,000 loss in 20x5 will be recognised in 20x6.

The journal entries for the two years will be as follows:

20x5

No entry is required

20x6

Dr Tax expense	75,000	
Cr Tax payable		75,000
(to record tax payable on profit of $300,000 for the year)		
Dr Tax receivable	25,000	
Cr Tax credit		25,000
(to record tax saving related to the loss of $100,000 carried forward)		

The above entries could, in fact, be combined as follows:

Dr Tax expense	50,000	
Cr Tax payable		50,000
(to record tax payable for the year)		

The relevant accounts will be shown in the 20x5 and 20x6 financial statements of B Ltd as follows:

Statements of comprehensive income

	20x5	20x6
	$'000	$'000
Profit/(loss) before tax	(100)	300
Tax expense	—	50
Profit/(loss) for the year	(100)	250

Statements of financial position

	20x5	20x6
	$'000	$'000
Liability		
Tax payable	—	50

Generally, where an entity has been operating profitably in the past years and the current year loss is "one-off", it may be argued that it is probable that future taxable profit will be available against which the loss carried forward can be utilised, and therefore deferred tax asset in relation to the tax loss is recognised in the year of loss, as shown in Illustration 51.22 above.

On the other hand, in cases where an entity has a history of recent losses, it will be difficult to argue that it is probable that future taxable profit will be available against which the loss carry-forward can be utilised, and therefore the tax benefit in relation to the tax loss is recognised only in the year in which the benefit is realised, as shown in Illustration 51.23 above.

However, if the entity has taxable temporary differences in the year of loss, HKAS 12 provides that the entity should recognise a deferred tax asset arising from the loss carried forward to the extent of the temporary differences (para 35). The rationale for the requirement of para 35 is that the taxable temporary differences will, upon reversal, result in taxable amount against which the loss carried forward can be utilised.

Illustration 51.24

C Ltd commenced operation in 20x1, and has been incurring losses. The cumulative loss as at 31 December 20x5 is $100,000. In 20x5, the company bought a computer, and as at 31 December 20x5, there is a taxable temporary difference of $120,000 in relation to the computer. The relevant tax rate is 25%.

In this case, the company will have to first recognise a deferred tax liability in relation to the taxable temporary difference, as follows:

Dr Tax expense	30,000	
Cr Deferred tax liability		30,000

Under para 35, the company shall also recognise a deferred tax asset in relation to the loss carried forward, given that there is sufficient taxable temporary difference against which the loss can be utilised, as follows:

Dr Deferred tax asset	25,000	
Cr Tax credit		25,000

The above journal entries could, of course, be combined as follows.

Dr Tax expense	5,000	
Cr Deferred tax liability		5,000

It may be noted that, in this case, where the amount of temporary differences is larger than that of tax loss, all the tax benefit of the tax loss is recognised in the year of loss.

The tax base of the building if it is used is $3 million and there is a taxable temporary difference of $6 million ($9 million – $3 million), resulting in a deferred tax liability of $1.8 million ($6 million at 30%).

The tax base of the land if it is used is $4 million and there is a taxable temporary difference of $2 million ($6 million – $4 million), resulting in a deferred tax liability of $0.4 million ($2 million at 20%).

As a result, if the presumption of recovery through sale is rebutted for the building, the deferred tax liability relating to the investment property is $2.2 million ($1.8 million + $0.4 million).

¶51-320 Current and deferred tax arising from share-based payment transactions

In some tax jurisdictions, an entity may receive a tax deduction that relates to remuneration paid in shares, share options or other equity instruments of the entity. The amount of that tax deduction may differ from the related cumulative remuneration expense, and may arise in a later accounting period. For example, in Hong Kong, an entity may recognise an expense for the consumption of employee services as consideration for share option granted, in accordance with HKFRS 2 "Share-based Payment", and not receive a tax deduction until the share option is exercised, with the measurement of the tax deduction based on the entity's share price at the date of exercise.

Paragraph 68C of HKAS 12 requires that current and deferred tax shall be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:

(a) a transaction or event that is recognised, in the same or a different period, outside profit or loss; or

(b) a business combination (other than the acquisition by an investment entity, as defined in HKFRS 10 "Consolidated Financial Statements" of a subsidiary that is required to be measured at fair value through profit or loss).

Under HKFRS 2, the tax deduction should be based on the option's intrinsic value (i.e. the difference between the market price and the exercise price of the option) at the end of the reporting period as the value at the exercise date will not be known.

The difference between the tax base of the services received to date (i.e. the amount of the tax allowance in future periods) and the carrying amount of zero will be a deductible temporary difference that results in a deferred tax asset.

If the amount of the tax deduction exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this situation, the excess of the associated current or deferred tax shall be recognised in other comprehensive income.

Presentation

¶51-400 Presentation

For presentation, there are two aspects, namely:

(a) the presentation of the current tax asset (liability) and deferred tax asset (liability) in the statement of financial position; and

(b) the related tax effect, which shall be accounted in the same way that the underlying transaction/events are accounted for (see the second principle mentioned at the beginning of the chapter).

¶51-410 Presentation of tax assets and tax liabilities

On the question of whether or not the tax assets shall be offset against tax liabilities, HKAS 12 applies the general rule for offsetting assets against liabilities.

Specifically, HKAS 12 provides that an entity shall offset current tax assets and current tax liabilities if, and only if the entity (a) has a legally enforceable right to set off the recognised amounts; and (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously (para 71).

As for deferred tax assets and liabilities, HKAS 12 provides that an entity shall offset deferred tax assets and deferred tax liabilities if, and only if (a) the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and (b) the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either the same taxable entity or different taxable entities which intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously in each future period in which the deferred tax assets and liabilities are expected to be recovered or settled (para 74).

¶51-420 Presentation of the related tax effect

The related tax effect shall, in accordance with the second principle of HKAS 12, be accounted in the same way that the underlying transaction/events are accounted for. Thus, the related tax effect shall be:

(a) presented in profit or loss, if the underlying transaction/event is accounted for in profit or loss;

(b) presented outside profit or loss (either in other comprehensive income or directly in equity, respectively), if the underlying transaction/event is accounted for outside profit or loss (either in other comprehensive income or directly in equity); and

(c) accounted for as an adjustment to goodwill if the underlying transaction/event arises from a business combination.

60 HKAS 26

"Accounting and Reporting by Retirement Benefit Plans"

¶60-100 Introduction

A retirement benefit plan is a separate accounting entity, for which a set of books is maintained and financial statements are prepared. Under HKAS 26 "Accounting and Reporting by Retirement Benefit Plans", retirement benefit plans are defined to be arrangements whereby an enterprise provides benefits for its employees on or after termination of service when such benefits, or the employer's contributions towards them, can be determined or estimated in advance of retirement from the provisions of a document or from the enterprise's practices. HKAS 26 governs accounting and reporting for such retirement benefit plans.

HKAS 26 complements HKAS 19 "Employee Benefits", which is concerned with the determination of the cost of retirement benefits in the financial statements of employers having plans.

¶60-200 Reporting by the plan

Retirement benefit plans may be defined contribution plans or defined benefit plans (para 5).

Defined contribution plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by contributions to a fund together with investment earnings thereon (para 8).

Defined benefit plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by reference to a formula usually based on employees' earnings and/or years of service (para 8).

For a defined contribution plan, HKAS 26 provides that its report should contain a statement of net assets available and a description of the funding policy (para 13).

For a defined benefit plan, HKAS 26 provides, under para 17, that its report shall contain either:

(a) a statement that shows the net assets available for benefits, the actuarial present value of promised retirement benefits (distinguished between vested benefits and non-vested benefits), and the resultant excess or deficit; or

(b) a statement of net assets available for benefits including either a note disclosing the actuarial present value of promised retirement benefits (distinguished between vested benefits and non-vested benefits) or a reference to this information in an accompanying actuarial report.

The actuarial present value of promised retirement benefits should be based on the benefits promised under the terms of the plan on service rendered to date using either current salary levels or projected salary levels. The report of the plan shall also explain the relationship between the actuarial present value of promised retirement benefits and the net assets available for benefits and the funding policy of promised benefits.

¶60-300 Accounting by the retirement benefit plan

In accounting by retirement benefit plans, as in the case of accounting by any other accounting entity, all the relevant Hong Kong Financial Reporting Standards are applicable.

HKAS 26 specifically provides that retirement benefit plan investments should be carried at fair value (para 32).

If a plan holds an investment for which an estimate of fair value is not possible HKAS 26 provides that the reason why the fair value is not used should be disclosed (para 32).

¶60-400 Disclosure

HKAS 26 provides, under para 34, that the report of a retirement benefit plan (whether defined contribution or defined benefit) should also contain the following information:

(a) a statement of changes in net assets available for benefits;

(b) a summary of significant accounting policies; and

(c) a description of the plan and the effect of any changes in the plan during the period.

Appendix A of HKAS 26 provides additional guidance on the preparation of financial statements of Mandatory Provident Fund Schemes and Occupational Retirement Schemes Ordinance Schemes.

¶60-500 Comparison with International Accounting Standards

HKAS 26 is based on IAS 26 "Accounting and Reporting by Retirement Benefit Plans". There are no textual differences between HKAS 26 and IAS 26. However, HKAS 26 includes an appendix that sets out additional guidance on preparing financial statements of Mandatory Provident Fund Schemes and Occupational Retirement Schemes Ordinance Schemes.

Compliance with HKAS 26 will ensure compliance with IAS 26.

61 HKAS 27 (2011)

"Separate Financial Statements"

¶61-100 Introduction

HKAS 27 (2011) "Separate Financial Statements" prescribes the accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity elects, or is required by local regulations, to present separate financial statements (para 1).

HKFRS 10 "Consolidated Financial Statements" was issued by the HKICPA in June 2011. HKFRS 10 is a replacement of HKAS 27 "Consolidated and Separate Financial Statements" and "HK(SIC)-Int 12 Consolidation — Special Purpose Entities". Concurrent with the issuance of HKFRS 10, the HKICPA also issued:

(a) HKFRS 11 "Joint Arrangements";

(b) HKFRS 12 "Disclosure of Interests in Other Entities";

(c) HKAS 27 (2011) "Separate Financial Statements" — the amendment reflects the changes required by the issuance of HKFRS 10 but retains the current guidance for separate financial statements; and

(d) HKAS 28 (2011) "Investments in Associates and Joint Ventures" — the amendment reflects the changes required by the issuance of HKFRS 10 and HKFRS 11.

HKAS 27 (2011) shall be applied in accounting for investments in subsidiaries, joint ventures and associates when an entity elects, or is required by local regulations, to present separate financial statements (para 2).

HKAS 27 (2011) becomes effective for annual periods beginning on or after 1 January 2013. Earlier application of HKAS 27 (2011) is permitted so long as HKAS 28 (2011), HKFRS 10, HKFRS 11 and HKFRS 12" are also applied early.

¶61-200 Separate financial statements

Separate financial statements are defined in HKAS 27 (2011) as those financial statements presented by a parent (i.e. an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with HKFRS 9 "Financial Instruments" (para 4).

Consolidated financial statements are defined in HKAS 27 (2011) as the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity (para 4).

Separate financial statements are those presented in addition to consolidated financial statements or in addition to financial statements in which investments in associates or joint ventures are accounted for using the equity method. Separate financial statements need not be appended to, or accompany, those statements (para 6).

An entity that is exempted in accordance with para 4(a) of HKFRS 10 from consolidation or para 17 of HKAS 28 (2011) from applying the equity method may present separate financial statements as its only financial statements.

Specifically para 4(a) of HKFRS 10 provides that a parent need not present consolidated financial statements if it meets all the following conditions:

(a) it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

(b) its debt or equity instruments are not traded in a public market;

(c) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

(d) its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with HKFRS or IFRS.

Illustration 61.1

P Ltd has a subsidiary, S Ltd. P Ltd is wholly-owned by U Ltd. They produce financial statements that are available for public use in compliance with the HKFRS. As a result, U Ltd presents consolidated financial statements in accordance with HKFRS 10.

In this case, P Ltd need not present consolidated financial statements because it is a wholly-owned subsidiary of U Ltd, and U Ltd, being the immediate and also ultimate parent of P Ltd, presents consolidated financial statements in accordance with HKFRS 10.

Illustration 61.2

P Ltd is a company listed on Hong Kong Stock Exchange and produces consolidated financial statements that are available for public use. P Ltd has 80% interest in a subsidiary, S1 Ltd. S1 Ltd owns 70% interest in S2 Ltd. S1 Ltd and S2 Ltd do not have their debt or equity instruments publicly traded and they are not in the process of issuing any class of instruments in public markets. P Ltd does not require its subsidiary S1 Ltd to present consolidated financial statements.

In this case, S1 Ltd need not present consolidated financial statements, provided it obtains the consent of the non-controlling interest holders not to produce consolidated financial statements.

¶61-300 Preparation of separate financial statements

HKAS 27 (2011) requires that separate financial statements shall be prepared in accordance with all applicable HKFRS (para 9).

When an entity prepares separate financial statements, it shall account for investments in subsidiaries, joint ventures and associates either (para 10):

(a) at cost; or

(b) in accordance with HKFRS 9.

The entity shall apply the same accounting for each category of investments. Investments accounted for at cost shall be accounted for in accordance with HKFRS 5 "Non-current Assets Held for Sale and Discontinued Operations" when they are classified as held for sale (or included in a disposal group that is classified as held for sale). The measurement of investments accounted for in accordance with HKFRS 9 is not changed in such circumstances (para 10).

Illustration 61.3

P Ltd has a subsidiary, S Ltd, and an associate, A Ltd. P Ltd prepares separate financial statements in accordance with HKAS 27 (2011) and selects the following accounting policies for its investments:

- Investment in subsidiary — at cost
- Investment in associate — at fair value

The cost of the investment in S Ltd at 1 January 20x9 is $8,000,000 and its fair value at financial year-end of 31 December 20x9 is $9,200,000.

The cost of the investment in A Ltd at 1 January 20x9 is $2,000,000 and its fair value at financial year-end of 31 December 20x9 is $2,400,000.

In this case, P Ltd, in its separate financial statements, can choose different accounting policies for different category of investments. Accordingly, the accounting policy choices that P Ltd would apply (i.e. cost model and fair value model for investment in subsidiary and associate respectively) complies with the requirements of HKAS 27 (2011).

P Ltd would recognise the investment in S Ltd at 31 December 20x9 at cost of $8,000,000. It would recognise the investment in A Ltd at 31 December 20x9 at its fair value of $2,400,000 with the gain from the change in fair value of the investment of $400,000 ($2,400,000 – $2,000,000) being recognised in profit or loss.

An entity shall recognise a dividend from a subsidiary, a joint venture or an associate in profit or loss in its separate financial statements when its right to receive the dividend is established (para 12).

¶61-400 Disclosure

An entity shall apply all applicable HKFRS when providing disclosures in its separate financial statements (para 15). For example, when a parent, in accordance with para 4(a) of HKFRS 10, elects not to prepare consolidated financial statements and instead prepares separate financial statements, it shall disclose in those separate financial statements (para 16):

(a) the fact that the financial statements are separate financial statements; that the exemption from consolidation has been used; the name and principal place of business (and country of incorporation, if different) of the entity whose consolidated financial statements that comply with HKFRS or IFRS have been produced for public use; and the address where those consolidated financial statements are obtainable.

(b) a list of significant investments in subsidiaries, joint ventures and associates, including:

(i) the name of those investees

(ii) the principal place of business (and country of incorporation, if different) of those investees

(iii) its proportion of the ownership interest (and its proportion of the voting rights, if different) held in those investees

(c) a description of the method used to account for the investments listed under (b).

When a parent (other than a parent described above) or an investor with joint control of, or significant influence over, an investee prepares separate financial statements, the parent or investor shall identify the financial statements prepared in accordance with HKFRS 10, HKFRS 11 or HKAS 28 (2011) to which they relate. The parent or investor shall also disclose in its separate financial statements (para 17):

(a) the fact that the statements are separate financial statements and the reasons why those statements are prepared if not required by law.

(b) a list of significant investments in subsidiaries, joint ventures and associates, including:

(i) the name of those investees

(ii) the principal place of business (and country of incorporation, if different) of those investees

(iii) its proportion of the ownership interest (and its proportion of the voting rights, if different) held in those investees

(c) a description of the method used to account for the investments listed under (b).

The parent or investor shall also identify the financial statements prepared in accordance with HKFRS 10, HKFRS 11 or HKAS 28 (2011) to which they relate.

¶61-500 Sample disclosures

Illustration 61.4

P Ltd has a wholly-owned subsidiary, S Ltd. The group prepares consolidated financial statements in accordance HKFRS 10. Further, P Ltd is required by law to present separate financial statements.

A sample disclosure from P Ltd's separate financial statements is shown below:

Note 1: Significant accounting policies

Investment in subsidiary (S Ltd)

The investment in S Ltd is measured at fair value with changes in the fair value of the investment recognised in profit or loss.

These parent entity's financial statements are presented in addition to P Ltd's consolidated financial statements for 20x9 prepared in accordance with HKFRS 10.